

BEFORE THE  
ALABAMA PUBLIC SERVICE COMMISSION



IN RE: PROPOSED REVISIONS TO THE )  
PRICE REGULATION AND LOCAL ) DOCKET 28590  
COMPETITION PLAN )

COMMENTS OF THE ATTORNEY GENERAL  
ON BEHALF OF ALABAMA RATEPAYERS



The Attorney General of the State of Alabama, on behalf of Alabama ratepayers of telecommunications services, submits the following comments in Docket 28590. The Alabama Public Service Commission has published three regulatory agreements for review. Although these agreements share common provisions, the three plans are independent versions of a proposed revision of the Price Regulation Plan adopted by the Commission in Joint Dockets 24499, 24472, 24030 and 24865, commonly referred to as the September 20, 1995, Local Competition Order (hereinafter the "1995 Local Competition Order.")

The PSC staff developed one of the plans (hereinafter the "Staff Plan") after reviewing the proposals submitted

by the independent ILECs (hereinafter the "Rural LEC Plan"), and BellSouth (hereinafter the "Metro Pricing Flexibility Plan" or "MPFP.") The staff developed its plan without any meetings or consultation with consumers or the Attorney General. Apparently, "[i]n late 1998, the APSC staff initiated discussions with various segments of the telecommunications industry regarding renewal of the 1995 Streamlined Regulation Plan...." Petition For Adoption of Streamlined Regulation Plan, ¶ 4, Alabama Public Service Commission Docket 28590, submitted on behalf of Rural LECs (January, 2003). The Attorney General was not aware of these discussions and was not invited to participate in any discussions of the plan in 1998.

Several days prior to December 7, 2001, representatives of the Attorney General became aware that the PSC staff was working on the Staff Plan. The PSC staff assured representatives of the Attorney General that the Attorney General would be able to participate in the meetings on the revision of the Staff Plan. The Attorney General was never invited to participate in any meetings and, upon inquiry, the PSC staff notified representatives of the Attorney General that the Staff Plan was on hold.

The independent ILECs filed proposed revisions to the 1995 Local Competition Order in January, 2003, and BellSouth filed the Metro Pricing Flexibility Plan on July 3, 2003. On September 22, 2003, the Commission ordered comments submitted on the Staff Plan, the Rural LEC Plan and the Metro Pricing Flexibility Plan on or before October 31, 2003.

The Attorney General, on behalf of Alabama consumers, hired an expert to review the proposed revisions to the 1995 Local Competition Order and requested an extension of time to submit comments. Dr. Marvin H. Kahn, an economist who is an expert in the field of telecommunications, reviewed the proposed revisions to the 1995 Local Competition Order and assisted the Attorney General in evaluating the plans. Dr. Kahn also represented the Office of the Attorney General in developing the 1995 Local Competition Plan. His technical analysis for this proceeding is attached as Exhibit A and incorporated by reference in these comments.

**I. DISCUSSION OF COMMON ISSUES RELEVANT TO THE STAFF PLAN, THE RURAL LEC PLAN, AND THE METRO PRICING FLEXIBILITY PLAN**

All three agreements need to be revised to incorporate the negotiated language that is an essential part of any agreement. The Commission staff wrote its plan to satisfy the concerns of the staff. BellSouth wrote the Metro Pricing Flexibility Plan incorporating only the terms and conditions necessary to meet the needs of the company. Likewise, the Rural LEC plan was written to satisfy the needs of the independent companies. The Attorney General recommends that the Commission schedule a meeting for participants to negotiate the actual language of any regulatory agreement that the Commission plans to approve for use in the State of Alabama.

A negotiated regulatory agreement will resolve many of the unanswered questions about the three plans. For example, the Staff Plan gives an ILEC 60 days to elect price regulation in lieu of rate of return regulation. If a company initially chooses rate of return regulation, the Staff Plan does not provide a procedure for an election of price regulation after the expiration of the initial 60-day time period. There are many other unanswered questions. A negotiated regulatory agreement would provide much greater detail on the proposals at issue in this docket.

Not only were the three proposals written to satisfy the concerns of the drafting parties, much of the language used in the agreements is confusing, ambiguous and vague. For example, the definitional section in the Staff Plan goes beyond defining terms to creating presumptions that certain new unnamed, undefined services will be "presumptively" defined as non-basic. Staff Plan, ¶ 2G. The definition of non-basic states that the presumption "shall" be mandatory "unless the Commission determines otherwise." Id. There is no provision for anyone to challenge whether a new service should be classified as non-basic. Any classification of new services must be addressed in the operative part of the agreement after the new service is identified. This is only one example of many uses of confusing, ambiguous, and vague language in the proposals. Scheduled meetings of the parties to negotiate, clarify, and explain certain provisions of the plans will result in more effective regulatory agreements.

All three proposed regulatory agreements give the companies certain rate increases without requiring any supporting data justifying the increases. The Rural LEC plan provides that the "ILEC will provide supporting

documentation with each tariff price change filing **when necessary** to demonstrate that the price change complies with the tariff pricing rules in Section 1.05." (emphasis added) Rural LEC Plan at 4, ¶ 1. The tariff pricing rules, on the other hand, do not contain any standards for the submission of supporting documentation. Id. at 4-7, ¶ 1.05.

The PSC may not pre-approve rate increases for the companies without investigating whether or not the increases are fair, just, and reasonable to the public. See Ala. Code § 37-1-80(b)(1992). The Staff Plan provides that basic service increases are limited to three percent on an annual basis. Staff Plan at 6, ¶ B. The example of such a filing is supposed to be contained in Appendix B, unfortunately; the proposed plan does not contain an Appendix B. Certain non-basic price increases are limited to five percent and others are limited to ten percent. Staff Plan at 7-9. (The other proposed plans have similar percentage limits.) The PSC staff does not provide any evidence indicating why the staff selected these particular percentage limits and until such evidence is available for

review, the Attorney General will not agree to the proposed percentage limits.

The three proposals do not provide a complete procedure for selling a service below cost. For example, the Staff Plan allows an ILEC, with Commission approval, to price a service below TSLRIC and/or UNE prices in order to meet the equally low price of a competitor. Staff Plan at 7, ¶ 4. The Staff Plan provides that revenue shortfalls from below-cost pricing may not be recovered from universal service funding. There is no provision in the Staff Plan prohibiting an ILEC from recovering revenues lost as a result of its below-cost pricing from rates paid by other customers. This practice should not be allowed without further study on whether this practice will result in discriminatory rates between customer classes. In a competitive environment, the PSC must not create a new set of subsidized prices that will bar efficient entry and prevent loss of customers. Maybe the company with the lowest price should get the customer without any assistance from regulators.

The Staff Plan, the Rural LEC Plan and the Metro Pricing Flexibility Plan, all require commission approval

for certain actions. Commission approval is never defined. Section 37-1-96 provides that "[n]o order shall be made by the commission affecting any rate or service, except as otherwise specifically provided, unless or until a public hearing has been held in accordance with the provisions of this title." Ala. Code § 37-1-96(1992). The plans need to address whether commission approval will include notice and a hearing or whether commission approval will be granted as one of the statutory exceptions, and, if an exception, designate the specific exception. The Attorney General recommends that commission approval always require a vote of the Commission after notice and a hearing.

All three proposals contain a paragraph allowing the companies to adjust prices to recover through intrastate rates the financial impact of certain state and federal governmental mandates. As a policy matter, this provision is inappropriate in a price cap regulatory agreement. Only companies regulated under rate of return regulation should be able to recover these costs. Any recovery of this type should, at a minimum, require notice, a hearing, and an order from the Commission.



The proposed plans limit a consumer's right to intervene and challenge a proposed rate. The 1995 Local Competition Order expressly provided that "[t]ariff filings, along with any categorization of services as basic or non-basic, will become effective as filed, unless there is intervention by a third party...." 1995 Local Competition Order, ¶ 13.06. Under the 1995 Local Competition Order, the Commission could order adjustments to customers' bills, if a particular rate ultimately were determined not to be just and reasonable.

The Staff Plan significantly restricts consumers' rights to challenge a particular rate by expressly reserving the right to the Commission, "in its discretion," to determine whether "suspension of a particular tariff is necessary due to third party intervention...." Staff Plan, ¶ 4D. The Rural LEC Plan provides, in footnote 4 referring to footnote 3 in a paragraph on tariffs disposition, that suspensions for price increases to basic services are not required due to third party interventions. Rural LEC Plan at 4, ¶ D, n. 3-4. The same plan provides, in footnote 7 referring to footnote 4, that the "Commission will not suspend" tariffs increasing the prices of non-basic

services. Id. at n. 4, n. 7. The Metro Plan provides that the Commission may investigate a tariff and hold a hearing on the tariff, on its own motion or by petition of another party, but that the Commission may not suspend a tariff pending the outcome of an investigation. MPFP, § 6. All three proposed regulatory agreements restrict a consumer's right to challenge a proposed rate. These restrictions on a consumer's right to intervene in a rate proceeding and challenge a rate are contrary to Alabama law.

The Alabama Legislature amended Title 37 in 1995 to permit alternative methods of regulation. Section 37-1-80(b) of the Alabama Code provides for the regulation of utility rates and services by methods other than rate of return regulation. Ala. Code § 37-1-80 (1992). This amendment reconfirms that the Commission retains its authority to establish rates and regulations for services furnished by the utility that are fair, just, and reasonable to the public. Id. Pursuant to this statutory amendment, the PSC established price cap regulation in the 1995 Local Competition Order. The PSC may not use its authority to implement alternative methods of regulation to exclude consumers from participating in rate proceedings.

The Alabama Supreme Court has held that, in rate proceedings, the PSC sits as an impartial tribunal. See Continental Telephone Company v. Alabama Public Service Commission, 479 So. 2d 1195, 1200 (Ala. 1985). If the PSC functions as an impartial tribunal, ratepayers must be allowed to participate in rate decisions by intervening in proceedings. Otherwise, the PSC will only have information from the company to consider in its decision of whether a rate is fair, just, and reasonable to the public.

The Commission's customer complaint procedures must be revised to accommodate the changing regulatory environment. More and more unregulated services are bundled with regulated services and the PSC needs to be able to assist Alabama consumers in resolving these complex issues. The current complaint procedures are even inadequate to assist consumers in resolving billing issues on interstate telephone calls.

## **II. THE METRO PRICING FLEXIBILITY PLAN**

The Metro Pricing Flexibility Plan significantly changes the regulatory procedures for BellSouth. The company asserts that regulatory restructuring is necessary

to allow the company to respond to changes in the market for telecommunications. The Attorney General agrees that changes in the market for telecommunications services can require changes in the structure of regulation and further, the extent of competition in the market is a critical determinant of the nature and extent of such changes.

BellSouth believes that the retail telecommunications market in Alabama is competitive. Whether the retail market is competitive is an issue that is subject to debate, particularly when the markets at issue are the residential and small business markets. While these markets are open to competition, Dr. Kahn's analysis proves that the markets are not yet competitive. Since competition is not fully established in Alabama, the market cannot be relied upon to discipline BellSouth's actions. The PSC must continue to ensure that Alabama ratepayers have the option of purchasing local telephone service at a regulated price.

The Attorney General does not object to BellSouth engaging in flexible pricing under the MPFP as long as the company continues to provide a regulated offer of local telephone service at the current price. If BellSouth

agrees to continue providing local service to Alabama ratepayers at the current price, customers will have a choice of telephone offers. They may choose to purchase the regulated service or they may choose to purchase services under the MPFP.

If the Commission approves the MPFP, the Attorney General specifically requests that the regulatory agreement be amended to incorporate the changes discussed throughout this comment. The general issues discussed above that are common to all three proposed regulatory agreements must be incorporated into the final draft of the MPFP.

Other issues are unique to the MPFP. Specific proposals that must be incorporated into the MPFP, include, but are not limited to, the following:

1. The definition of bundled services must be revised to include BellSouth's regulated services.
2. Standards must be developed for use of the term, "competitive alternative."
3. Deletion of the term, "Presumptively (or Presumed) Valid" throughout the agreement.
4. The agreement must be amended to provide that a tariff may be denied if, after investigation, the

tariff is found to violate the rules and regulations as set forth in the MPFP, the tariff violates any provision of Title 37, or the PSC finds that the tariff is not in the public interest because it is not fair, just, and reasonable to the public.

5. Commission approval is defined to require a vote of the Commission after notice and a hearing.
6. A third party petition for intervention is timely, if filed within the relevant time period. A shorter period for intervening may be required when all potential parties receive actual notice of a filing. BellSouth agrees to waive any notice period for a hearing, if the PSC needs to schedule the hearing in less than the usual time frame to accommodate the relevant time period for issuing an order on a rate.
7. If the PSC fails to act within a designated time period, the company's request shall be deemed denied rather than deemed approved.
8. The PSC retains its right to suspend tariffs under Title 37. The PSC retains the right to suspend

and investigate an item on the Price List and, for purposes of the investigation, an item on the Price List will be treated as a tariff.

9. When a company chooses to implement a tariff or a price on the Price List during an investigation, the PSC may order refunds or any other retroactive relief, if the tariff or price is denied or modified after the investigation. The company bears the risk of charging for a service that has not been approved by the Commission.
10. The MPFP shall establish procedures for notification and pricing of services that will be eliminated, deemed obsolete, or grandfathered.
11. No services, other than basic services, may be sold below LRIC.
12. The PSC will investigate whether the pricing rule limit of five percent is fair, just, and reasonable to the public and, after reviewing evidence on the appropriate percentage, the PSC will issue an order authorizing the appropriate pricing rule percentage. The order shall include

the time frame for application of the designated percentage.

13. BellSouth agrees to sell its bundled services throughout the state.
14. The filed rate doctrine will not apply to non-tariffed services or services included in the Price List.
15. The Commission will develop consumer protection rules and regulations similar to those in effect for non-regulated companies. These rules and regulations will apply to the MPFP. Since there are no precedents for consumer protection rules in Alabama and to ensure uniformity among the states, BellSouth must agree that the PSC may use as precedents on consumer protection issues, any decisions from Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee.
16. The Commission will develop dispute resolution procedures for resolving customer complaints for all bundled services that include regulated services.



17. Customer notification of price increases will include the increases for all regulated prices and all bundles that contain regulated services. The notice must include a reasonable time to respond to the price change and a specific date by which the customer may cancel the service to avoid paying the increase.
18. All filing and notice requirements, including transmittal letters, under the MPFP must include the Attorney General.
19. Promotions and Customer Value Programs must be available throughout the state to all customers in all geographic areas and all wire centers.
20. In the event of a conflict between the MPFP and Title 37, the provisions of Title 37 will prevail.
21. The paragraph on the effects of extraordinary governmental actions must be deleted because the paragraph is inconsistent with the purpose of the MPFP.

Many of the issues listed above may be resolved through informal negotiations with BellSouth. If informal negotiations are not successful, the Attorney General

recommends that the PSC include the MPFP in the workshop requested on the Staff Plan or any similar workshop proceeding.

### III. CONCLUSION

The Attorney General recommends that the PSC designate a workshop for reviewing and revising the Staff Plan. The purpose of the workshop would be to clarify the language of the agreement and to reconcile any differences between the proposed regulatory agreement and the requirements of Title 37.

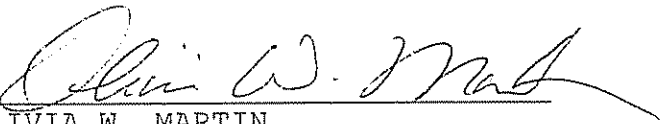
The Attorney General further recommends that any decision on the Rural LEC Plan be delayed until competition develops in the rural areas. The Attorney General does not object to a specific regulatory agreement for rural LECs, but the passage of the proposed Rural LEC plan is premature at this time.

The MPFP, amended to incorporate the provisions discussed in these comments, would benefit Alabama ratepayers. Ratepayers throughout the state would have the advantage of purchasing a regulated offer of local service or purchasing telecommunications service under the MPFP.

The Attorney General recommends approval of the MPFP and the regulated offer of local service as soon as the regulatory agreement is amended to include the protections for ratepayers discussed in these comments.

Respectfully Submitted,

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## EXHIBIT A

### TECHNICAL ANALYSIS OF ISSUES RELATED TO REVISIONS TO THE PRICE REGULATION AND LOCAL COMPETITION PLAN ANALYSIS OF MARKET COMPETITION AND PRODUCTIVITY ISSUES

Prepared by Marvin H. Kahn

#### I. Introduction.

Regulation remains necessary when competition has not successfully emerged in the marketplace. The lack of competition may result from the fact that it cannot thrive in particular segments of the market or, alternatively it can, but has not yet successfully emerged to the point where it can be relied upon to discipline the incumbent's action in the marketplace. If unregulated, a firm with monopoly power - even transitional monopoly power - can benefit by restricting output, effecting the terms and conditions of sales and/or raising prices to gain profit not available in a competitive marketplace. The regulator must ensure that the regulated entity operates with prices, terms and conditions for services that do not reflect unchecked monopoly power. In Case No. 24499, the PSC adopted a policy of price caps in place of traditional rate of return regulation as a mechanism by which it regulates the actions of the local exchange companies in the state. The Attorney General agrees that this is a reasonable approach to regulation, especially in circumstances where the local exchange company provides services in both competitive and non-

competitive markets. However, to be effective, the price caps themselves must ensure that the prices charged are consistent with public policy goals and a competitive outcome rather than unchecked monopoly power.

To accomplish that, where prices pertain to specific or individual regulated products or services, it is necessary to gauge the price cap relative to the underlying costs of the service in question, or alternatively to gauge the trend in prices allowed by the price cap mechanism relative to the expected trend in the cost of the underlying product or service in question. In other instances, prices pertain not to individual products, but rather to combinations or bundles of products and services. Further, there are circumstances, and circumstances that are increasingly common, where the bundles are not made up exclusively of regulated products and services. In that circumstance, a price cap or price ceiling *per se* cannot be established. Nevertheless, the Commission has a responsibility to ensure that the offering of the regulated service is accomplished in a manner that remains consistent with the underlying goals of regulations and policies of the PSC.

## II. Recommendations

Bundled Services. It is important that the regulatory structure provide an opportunity for a market-based response, where the market can be characterized as competitive. In

competitive markets such responses can be presumed to be in the ratepayers' best interest. At the same time, the regulatory structure must address the possibility of anti-competitive responses where the market structure is not yet competitive.

For instance, bundling can be to the public advantage. If the bundle were made up entirely of regulated products or services, the PSC would have the responsibility to ensure that the pricing, terms and conditions offered for the bundle were reasonable. In today's market, bundles often include combinations of regulated and unregulated products and services. The Attorney General believes that the PSC has a responsibility and the authority to ensure that regulated ratepayers are treated fairly and reasonably in terms of these bundles. To ensure that competition in the regulated market place benefits the ratepayer, the PSC must provide a forum to adjudicate disputes between consumers and any regulated entity whenever a regulated service is part of any service package.

Basic Service Offering. The PSC should require each of the incumbent local exchange carriers to continue to offer local flat rate service in a manner that is separate or unbundled from other service offerings. While competition may promote service bundling in the marketplace, there is a segment of the market, particularly low-income households, that is interested in obtaining local telephone service separate and apart from any of

the other features or functions that may be available. That basic service package should be available and should be made available at affordable rates.

Before turning to the specifics of the Attorney General's proposals, we first examine the extent of competition in the residential segment of the telephone service market. BellSouth premises much of its proposal on the competitive nature of the markets it serves. While there have been many changes in telephone markets over the past several years, we show that the incumbent local companies have maintained their dominance in the residential segment of the market.

### III. The Market for Residential and Small-Business Services Is Not Competitive.

The Federal Telecommunications Act of 1996 announced a national policy of turning to competitive market forces rather than regulated monopoly to meet our telecommunications goals. The Preamble explains that the Act is meant to <sup>1</sup>

...promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.

Currently, we are on that path leading from regulated monopoly to competition. Based on recent experiences, the path will probably not be straight and by all appearances may not be

short. In fact, as discussed further immediately below, it appears that we are much closer to its beginning than to its end. Supporting this view is the fact that BellSouth continues to account for more than 87.5% for the market for residential and small-business local telephone service.

Consider the following: The FCC reports that CLECs nationwide provide approximately fifteen percent of the wireline connections to the public switched telephone network, but in Alabama CLECs provide only about 10 percent of the connections..<sup>2, 3</sup> These figures are averages and pertain to service to all customers and all customer classes, whereas competition is not equally intense in each market segment. In Alabama, sixty-two percent of CLEC lines serve large business customers whereas only seventeen percent of ILEC lines serve this customer segment.<sup>4</sup> Thus, competition is far more advanced in the large business (or "enterprise") market segment than in the residential and small-business (or "mass market") segment. While competition disciplines may some ILEC actions in the market for large business services, that is not the case, or at least not yet the case, in the residential and small-business segment of that market. The same conclusions apply to BellSouth Alabama

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<sup>1</sup> Preamble, Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996)

<sup>2</sup> FCC, Local Telephone Competition: Status as of June 30, 2003.

[http://www.fcc.gov/Bureaus/Common\\_Carrier/Reports/FCC-State\\_Link/IAD/lcom1203.pdf](http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom1203.pdf)

<sup>3</sup> Wireline demand is met by CLECs through the use of ILEC facilities (Resale, UNEs and special access) or CLEC facilities (special access, fiber networks or coax)



operations, viz. BellSouth maintains a dominant share of the market for residential and small business lines.

This Commission and the FCC have concluded that barriers to entry into this market have been reduced, pursuant to Section 271 of the Telecommunications Act. However, it is essential to recognize that "open to competition" is not the same as "competitive." Removing barriers to entry is a necessary first step in the move from monopoly to competition, not its culmination. For instance, the FCC reports that in June 2003 only seven CLECs were operating at material volumes in Alabama.<sup>5</sup> Moreover, BellSouth has an 89.70% share of the wireline connections provided to mass-market customers in its service territory. If we add those who use wireless or voice over internet protocol in place of wireline -- as opposed to those who use it in addition to wireline -- BellSouth has an 87.5% share. BellSouth data and its market share are shown in Table 1. These data are derived largely from BellSouth and CLEC Form 477 reports to the FCC.

As noted, these data and analysis go to not only wireline but also to wireless presence in the market and the implications thereof. CLECs can serve customers using ILEC facilities in the

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<sup>4</sup> *Ibid*

<sup>5</sup> *Ibid*. The FCC threshold for including a CLEC is that it provide at least 10,000 lines. BellSouth suggests that there are 70 CLECS authorized to operate in Alabama. See Petition of Bellsouth Telecommunications Inc. For The Adoption of Metro Pricing Flexibility Plan, p. 3. Apparently, most of these are either not very active or not very successful. In fact, some may not even be operating.

form of resale, UNE Loop (UNE-L with CLEC switching) and UNE Platform (UNE-P with ILEC switching) or their own facilities. Data on the number of lines provided on a total resale and on a UNE-P basis as well as the fraction of each that serve mass market consumers are available from the BellSouth Form 477 Reports. Data on the number of loops provided on a UNE-L basis are similarly available, but the breakout of the fraction serving each customer class is not. Given that over half of all CLEC lines serve enterprise customers and that resale and UNE-P are used almost exclusively to serve mass-market customers, its unlikely that anything but a small number of the UNE-L are used to serve the mass market. To ensure that this analysis does not understate the market share of CLECs or overstate the BellSouth market share in the residential and small business market segment, we have included one-third of the UNE-L lines provided to CLECs in Alabama as being used to serve residential and small business customers.

CLEC owned facilities are typically fiber optic rings, special access lines or coax cable. Fiber rings and special access are most frequently used to serve enterprise customers. On the other hand, coax is used almost exclusively by the Cable TV industry, which serves primarily residence and small business customers. For the last several years between 45 and 50 percent of CLEC owned lines have served residential and small

business customers.<sup>6</sup> We have included as coax in Table 1 fifty percent of the CLEC owned facilities in place in Alabama, even though a portion of these facilities may serve customers outside the BellSouth service area. Using the 50 percent allocation ensures that the BellSouth market share is not overstated. Considering CLECs use of ILEC lines and of CLEC owned lines, we estimate that BellSouth has an almost ninety percent share of the wireline market for residential and small business customers in Alabama.

There are two other service platforms to consider: wireless and voice over internet protocol. While there is ample evidence to suggest that wireless could be or might be a potential competitor to wireline that is not the case today and is likely not to be the case in the near future. For instance, in 2002, approximately 60% of the households nationwide had one or more wireless phones.<sup>7</sup> Estimates place the number of households using a wireless phone in place of their main wireline phone as high as 1.2 percent<sup>8</sup> and the number of subscribers viewing their wireless as their primary phone as high as 3 to 5 percent.<sup>9</sup>

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<sup>6</sup> FCC Local Telephone Competition, June 2003.

<sup>7</sup> FCC, Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services, Seventh Report, 2002. 17 FCC Rcd 12985, 13016. (Seventh Wireless Report)

<sup>8</sup> FCC, Universal Service Monitoring Report, 2003, p. 6-2. The estimate was prepared by the Department of Census from its Current Population Reports. The FCC chose not to rely on this in its Telephone Subscribership analysis, presumably because of concerns regarding statistical reliability.

<sup>9</sup> Seventh Wireless Report, *op cit* 13017.

In its most recent Triennial UNE Review, the FCC considered these and other similar facts in assessing the importance of wireless as a substitute for wireline in the residential and small business segment of the telephone market. The FCC recognized that wireless use was widespread and that it has the technical capability of being used in place of a wireline connection, quality of service and price differences, among other factors, were sufficient to prevent wireless from being a viable alternative at this time. As the FCC described it, wireless had not yet "blossomed into a full substitute for wireline telephony"<sup>10</sup>. Furthermore, it should be noted that BellSouth offers packages that integrate its wireless and wireline services by allowing wireless calls to be forwarded to the wireline call with no charge for wireless minutes. The quality of service and price differentials and this type of integration suggest that the relationship between wireless and wireline may be better described as one of compliments rather than one of substitutes.

Recognizing that some subscribers probably do take wireless in place of wireline as their main telephone and others may use it in place of second lines, we have included an estimate of wireless penetration in this market in place of wire lines. Our

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<sup>10</sup> Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, In the Matter of Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, CC Docket No. 01-338 *et. al.* FCC 03-36. (Triennial Review Order) para. 245

estimate is three percent of households, a figure that is approximately the mid point of the estimates of wireless substitution provided above.

Voice over IP (VoIP) is another technology that can bypass portions of the telephone network and provide telecommunications. VoIP is not an infrastructure, but rather a form of voice carriage using packet rather than circuit switching, and performs best when operating over a broadband connection. As such, VoIP can ride on any of several infrastructures, including traditional telephone lines. In fact, BellSouth has recently announced its intention to devote substantial resources to the development of VoIP technology as a delivery system within its network.<sup>11</sup>

Relying on broadband means that VoIP could be used on a DSL or on a cable line. If used in conjunction with DSL, there is no bypass as BellSouth continues to provide full carriage. To the extent that VoIP is used over a cable television system, we have included cable lines in the analysis already. Consequently, no material impact of VoIP on the market, separate from DSL and cable lines, can be expected.

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<sup>11</sup> "Bellsouth To Ramp Up VoIP Services for Business Customers", <http://www.techweb.com/wire/story/TWB20031030S0012>; "Bellsouth Harnesses the Power of Voice Over IP"; Fortifying E-Platform Evolution, [http://newsroom.cisco.com/dlls/corp\\_060401b.html](http://newsroom.cisco.com/dlls/corp_060401b.html); "BellSouth Delivers the Package", <http://www.destinationcrm.com/articles/default.asp?ArticleID=3582>

Considering both wireline and the alternatives to wireline, the BellSouth market share is estimated to be approximately 87.54 percent.

Competition may or may not increase over time. The 1996 Act anticipated that cable TV would almost immediately provide the second wire into the house. That still has not happened. For whatever reason CLEC have not been the force their numbers initially suggested. And, to date none of the RBOCs have entered in any substantial way the service territory of other RBOCs. The PSC should attempt to provide flexibility consistent with the extent of competition. Competition has not yet emerged in the residential market segment, as Bell retains a dominant market share.

#### **IV. Basic Service Pricing**

The Attorney General proposes that a basic service offering at affordable prices be a required component of any regulatory structure. Specifically, the Attorney General proposes that basic service prices be retained at current rates for the next three years and after that be allowed to increase by no more than one-half the rate of inflation as measured by the Gross Domestic Product Price Index (GDPPI). Furthermore, if the PSC chooses to approve the BellSouth Special Recovery of Extraordinary Governmental Actions provision, it should not apply this provision to basic services.

The Attorney General's Proposal is reasonable in light of BellSouth and industry trends in costs and financial ability to modernize its network.

The PSC recognized in Docket No. 24499, et. al. the importance of productivity generated cost offsets in setting LEC prices. In its 1995 Local Competition Order, the PSC established specific price changes for the first five years of the plan and after that limited basic service price increases to the rate of inflation less a three percent productivity offset for BellSouth and the rate of inflation less a one percent productivity offset for all other local exchange companies.

Productivity growth serves as an offset against costs incurred. If prices paid by a telephone company increased on average, by, say three percent and productivity also increased by three percent, then unit costs would remain unchanged. In other words, even though the prices paid for inputs into its production process have gone up, the telephone company in this circumstance can continue to provide service with no change in rates and continue to be as profitable. If productivity outpaces the rate at which the prices paid for inputs into the production process increase, then either (a) service prices can remain unchanged and profitability will increase or (b) service prices can be reduced and profitability remain unchanged. For

this reason, regulators have relied on measures of productivity growth experienced by the telephone companies to determine the extent to which prices may increase or need to decrease to remain reasonable.

Productivity in the telecommunications industry has remained strong since 1995, even with dramatic changes in the U.S. economy and in the telecommunications industry. The total Factor Productivity (TFP) growth experienced by BellSouth exceeded 3.24 percent per year over this period.<sup>12</sup> See Table 2. In other words, unless the rate of inflation for the goods and services used by BellSouth to produce telephone services exceeds 3.24 percent per year, there will be no need for BellSouth to increase prices for its regulated services to be able to fully recover all costs incurred and maintain its level of profitability.

This rate of productivity advance is indeed significant for several reasons. First, the rate of productivity growth experienced by telephone companies has regularly outpaced that experienced by the economy as a whole. For instance, over this same time period the rate of multi factor productivity growth experienced for the U.S. economy as a whole averaged 0.8 percent. See Table 3. Second, 1996-2002 was a time period in

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<sup>12</sup> The derivation of total factor productivity for BellSouth Alabama operations drawing on information provided by BellSouth in its ARMIS Reports to the FCC is presented below.



which the market for local telephone services was opened to competition. Consequently, there is no reason to expect that BellSouth will be incapable of maintaining this rate of productivity advance over the next several years, at least. Third, technological change continues to be commonplace in the telecommunications industry. Recent announcements regarding the deployment of fiber in the local network and the expanded use of VoIP as a means of carrying voice and data messages underscore the probable magnitude of this trend. Fourth, the rate of inflation is expected to remain at low levels for the near and intermediate term<sup>13</sup>, BellSouth's rate of productivity growth is expected to remain above the rate of inflation for the next several years anyway. That suggests that the prices paid by BellSouth for its inputs into its production process are not likely to increase by as much as the rate of productivity growth. Stated differently, BellSouth is likely to be in a declining cost situation over the next several years at least.

Being mindful that projections of future rates of inflation are always speculative, the Attorney General proposes only that rates for local service remain unchanged - as opposed to be decreased - over the next several years and that price increases

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<sup>13</sup> When recently asked if Federal Reserve officials were worried that several quarters of rapid economic growth could cause a burst of inflation, Federal Reserve Chairman Alan Greenspan responded that the Federal Reserve could be "patient." <http://www.washingtonpost.com/wp-dyn/articles/A51232-2004Jan3.html>

beyond that be limited to one half the rate of inflation, recognizing a productivity offset.

The PSC identified its objectives for price regulation for local competition to include the encouragement of the introduction of new technology and modern services in all areas of Alabama, both urban and rural.<sup>14</sup> The Attorney General proposal is consistent with that objective. Specifically, an examination of BellSouth's financials indicate that it does not need higher prices in order to generate revenues that would allow it to undertake additional investments. For instance, BellSouth's current rate of depreciation accrual is sufficient to fully finance the rate of its investment in network facilities over the last several years. As shown in Table 4, the depreciation expenses accrued annually from 1996 through 2002 have been sufficient to fund between ninety-six percent and ninety-eight percent of the total investment undertaken by BellSouth during that time period. Outside financing was not critical to meeting BellSouth's infrastructure requirements.

In addition, BellSouth's earnings capability, even during a period when its markets were opened to competition, demonstrates its ability to continue to generate internal funds to meet investment requirements. In Table 5, we show BellSouth operating revenues, operating expenses and the residual, which

we refer to as property income, is the amount available for interest, dividend payments, return to stockholders and taxes. We also show BellSouth's investment and the property income as a percentage of that investment for each of these years.

For purposes of this analysis, we select the first year of a plan initiated in Docket No. 24499 as the base period. We accept the 1996 earnings level as reasonable, and use it as a benchmark for earnings throughout 1996- 2002 period. As indicated here, in 1997 property income as a percent of investment 'fell below the 1996 level,' and rose above that benchmark in 1998 and remained above it through 2002. In short, BellSouth's ability to generate sufficient revenues to meet financial requirements will not be jeopardized by the Attorney General's proposal for the pricing of basic services.

The Attorney General's proposal does not require that rates for basic services benefit from cost reductions expected to occur over the next few years. Instead this proposal accepts existing rates as reasonable and generally affordable, and attempts only to ensure that these rates remain affordable going forward. Had the proposal been strictly cost based, calling for rate reductions whenever costs fall, the BellSouth Special Recovery proposal would be reasonable. With it, rate changes would be tied to (1) the difference between inflation and

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<sup>14</sup> ALPSC Docket 24499 Report and Order, p 3.

productivity growth to capture the effects of general cost trends and (2) a factor such as the BellSouth Special Provision which would pick up the effect of narrowly focused, industry or region specific cost changes. However, the Attorney General's proposal is not strictly cost based, in that basic service rates can increase even when costs decrease. In this context, the BellSouth Special Provision is simply another source of rate increases. The provision is wholly arbitrary and should not be approved.

#### **BellSouth Alabama Total Factor Productivity**

Productivity is a measure of output per unit input, and productivity growth is a measure of the change in output over time relative to the change in inputs over time. Total factor productivity or TFP encompasses all the inputs used in the production process and in that manner captures the productivity advance associated with each of the inputs used. Productivity growth is of interest in the regulated rate setting process in that it provides a basis for determining the expected cost and cost trends of the regulated entity. Firms and industries that experience the highest rates of productivity advance tend to also experience the lowest rates of cost increase, and in a competitive market place, the lowest rates of price increase. In fact, firms or industries that experience productivity growth

that outpaces the increase in prices paid for inputs into its production process experience absolute cost decreases.

The productivity growth experienced by the telephone industry has consistently outpaced productivity growth in other industries and in the economy overall. As such, cost increases in the telephone industry have generally been less than the national average and on many occasions (especially when inflation has been modest) there have been absolute cost decreases.

As noted above, productivity growth is defined as the growth of outputs from a production process relative to the growth of inputs used in that same production process. A productivity calculation for BellSouth Alabama for the years 1996 through the 2002 (the most recent date for which data are available) is in Table 6. This analysis was performed without the benefit of discovery and, therefore, relied strictly on publicly available data. Specifically, the data utilized were derived primarily from the BellSouth ARMIS Reports to the FCC.<sup>15</sup>

#### Derivation of Outputs

The derivation of output and output growth begins with revenue data. Revenue growth is the change in outputs plus the change in prices charged for those outputs. If the revenue

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<sup>15</sup> In the event that the PSC chooses to hold hearings on these matters, the Attorney General will seek discovery allowing it to make more detailed and more accurate assessments of revenue changes to be included in this analysis.

stream is adjusted by eliminating or accounting for price changes, then this price adjusted revenue stream provides a first proxy for the changes in output over time.

Data on annual revenues are from the ARMIS Joint Cost Report, 43-03. Data on the revenue impact of various BellSouth rate changes are reported as "significant changes," in the ARMIS USOA Report 43-02. BellSouth reports the revenue impact of its changes to intrastate rates and tariffs on a state specific basis and the revenue impact of changes to its interstate charges on a region wide basis. Not having information on the state specific impact of region wide revenue changes, we excluded these from the analysis. As a result, not all rate changes have been included in the analysis. This is important since access charges were regularly reduced over this time period, which means that revenue reductions from rate changes have been excluded from the analysis and that the rate of output growth exceeds the rate of growth shown for the price adjusted revenue stream. The intrastate revenue adjustment derived from the information in the ARMIS 43-02 Reports are shown as "revenue adjustments" in Table 6. The levels and growth in price-adjusted revenues for 1996 and 2002 are shown.

#### Derivation of Expenses

The growth rate of expenses over time is equal to the growth in the volume of inputs into the production process plus

the growth in the prices paid by BellSouth for these inputs. Measuring total dollar expenditures and controlling for price changes by BellSouth provides a first proxy for the growth in inputs over time

Traditionally in telephone productivity analysis, inputs are labor, capital and materials. BellSouth reports labor, materials and depreciation expenses as operating expenses in its ARMIS Reports. To complete the analysis of total expenses, we must add to operating expenses a measure of capital costs including return to stockholders, interest and taxes.

For purposes of this analysis, we use the capital cost realized by BellSouth in 1996, the first year of the recent price cap plan, expressed as a percent of net plant, as a benchmark. Specifically, we calculate the actual interest, return and taxes for BellSouth from its ARMIS Report filing and express that as a percentage of net investment. That percentage of net investment is then used as the appropriate capital cost for each year in the analysis, the year 2002 in this particular instance.<sup>16</sup> The sum of operating expenses and capital costs provides our measure of total expenses for the years 1996 and 2002. We deflate these expenses by the gross domestic product

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<sup>16</sup> Using the same measure of return for the entire period 1996 though 2002 presumes no change in the underlying cost of capital over this time period. If, the cost of capital declines over this time period, as the Attorney General believes it has, the measure of expenses and expense growth used here is higher than it would be with a more accurate calculation. The result is to overstate the growth in Bellsouth expenses and correspondingly understate the rate of productivity growth

price index (GDPPI), a broad based price index representing the average change in prices throughout the economy, to account for price increases to BellSouth inputs. BellSouth in testimony before state and federal regulatory authorities has regularly taken the position that the rate of inflation or price changes for inputs used by the telephone industry has not been significantly different than the rate of inflation experienced nationwide as measured by the GDPPI.. That is, GDPPI can be used as a first proxy for the rate of price increase experienced by BellSouth for the inputs used in its production process. The annual growth in inputs, measured as deflated expenses, is also shown.

Finally, the comparison of the growth in outputs and inputs is shown and the growth in TFP over this period is calculated.

#### V. The PSC Must Take Responsibility for the Bundling of Regulated and Unregulated Services.

Packages or bundles of services, where two or more distinct services are offered as one service at a single price, are becoming increasingly commonplace. At one time, LECs offered bundles made up primarily of basic local exchange and vertical services. With traditional long distance carriers entering the local service market and with the ILECs gaining entry into the long distance market, long distance services are being bundled with local services. In today's market- place, bundles include



not only these services, but also DSL and wireless services, among others.

There is reason to suspect that bundles will be more popular with residential and small business customers than with large business customers. Large business customers often have specific technical requirements associated with their services, --whether local, long distance, broadband or wireless -- which a bundle of standard services is not likely to meet. In addition, the volumes of service taken by large business customers may well make it worth their while to contract for these services individually. Residential and small business customers could readily see the advantage of "one stop shopping," with one bill to pay, one phone number to call for service and one supplier with whom to deal. As such, it is likely to be the small rather than the large customers who are most attracted to bundled service packages.

While bundled service packages may indeed offer benefits to consumers, there are also concerns that must be recognized. Specifically, the customer has to deal with the bundle as if it were a single service and not as a package made up of individual regulated and individual unregulated components. Issues with regard to billing, service quality, or contract terms are subject to the terms in the package, not to the tariffs on file with the PSC. In essence, at the present time, if a customer

takes a bundled service package made up of regulated and unregulated services, the customer gives up certain rights and PSC protections.

While the PSC should promote the opportunity for a competitive market response, it must at the same time limit the opportunity for anticompetitive responses. For instance, the PSC or its staff has the opportunity to review the cost associated with any regulated service or bundle of regulated services offered. This is the case of the service or package offered pursuant to the company's tariffs or its Contract Service Arrangement (CSA).<sup>17</sup> If, however, a bundle includes both regulated and unregulated services, the same set of requirements do not currently apply to all services included in that package. Unless the PSC or its staff has the opportunity to review the costs of the regulated as well as the unregulated services, the concerns raised with regard to prices relative to costs simply cannot be addressed. It would be incomplete regulation if the policy concerns that led to the requirement that cost information be made available are not addressed in the instance where a package is made up of both regulated and unregulated services.

An appropriate regulatory framework is one that grants LECs flexibility consistent with the extent of competition in the

marketplace. This type of framework provides LECs with the ability to offer services and service packages and to offer them at prices that are responsive to customer needs, while at the same time ensuring that LECs do not use flexibility to deter efficient entry or engage in predatory behavior and do not unreasonably increase rates or set service terms for customers that lack competitive alternatives.

If all regulated and all unregulated services were offered in workably competitive markets there would be few concerns raised by the bundling of regulated and unregulated services. The markets for basic telephone services are just emerging from monopoly positions and are not fully competitive at this point. Consequently, it would be most inappropriate for ratepayers to have to give up the right of PSC protection if they choose to take a package made up of both regulated and unregulated services.

The Attorney General is not suggesting that the bundling of regulated and unregulated services not be allowed. Indeed, bundling can, with the proper market protections, be in the ratepayer's best interest. The Attorney General instead suggests that the appropriate protections be put in place. Specifically, the Attorney General proposes that the PSC must provide a forum for the adjudication of disputes between

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<sup>17</sup> Bellsouth Metro Proposal, *op. cit.*, Exhibit 1, p. 7.

consumers or competitors and any ILEC whenever the regulated service is part of any service package.

**Table 1**  
**Bellsouth Market Share**  
**Switched Access Lines**  
**Residential and Small Business Market Segment**  
**December 2002**

Bellsouth End Users	1,455,510
CLEC Lines from Other Carriers	
Resold Lines	37,186
UNE _Loop (CLEC Switching)	4,880
UNE-P (ILEC Switching)	106,979
CLEC Owned Lines	
Coax	18,164
Wireless	40,122
Voice over Internet Protocol	#
Subtotal Wirelines	1,622,720
Total Lines	1,662,842
Bellsouth Share	
Wireline	89.70%
Total Market	87.53%

Notes: #, less than 1%

Source: Bellsouth and CLEC Lines, FCC Form 477  
Coax, estimated as 50% of all CLEC owned lines,  
FCC Local Telephone Competition: Status  
as of June 2003  
estimated as 3% of  
Wireless, households

**Table 2**  
**BellSouth Alabama Productivity**  
**TFP Growth 1996-2002**  
**(\$millions)**

	<u>1996</u>	<u>2002</u>	<u>Annual Growth</u>
Total Output	1,195	1,393	2.56%
Total Input	1,186	1,138	-0.68%
TFP Growth			3.24%

**Table 3**  
**US Multifactor Productivity**  
**Growth Rates**  
**1996-2001**

<u>Date</u>	<u>Rate</u>
1996	1.4%
1997	1.0%
1998	1.2%
1999	0.7%
2000	1.4%
2001	-1.0%
Average	0.8%

Source: <http://data.bls.gov/servlet/SurveyOutputServlet>

**Table 4**  
**Bellsouth Depreciation Accruals as a Percent**  
**of Plant Additions**  
**1996-2002**  
**(\$ thousands)**

<u>Year</u>	<u>Plant Additions</u>	<u>Depreciation Accruals</u>	<u>Percent</u>
1996	336,709	308,919	91.75%
1997	344,272	321,613	93.42%
1998	327,492	345,149	105.39%
1999	320,766	317,574	99.00%
2000	395,959	322,606	81.47%
2001	383,956	342,236	89.13%
2002	254,264	360,685	141.85%
Totals	2,363,418	2,318,782	98.11%



Table 5  
BellSouth Earnings  
Property Income 1996-2002

	2002	2001	2000	1999	1998	1997	1996
<b>Property Income (\$)</b>	520,608	565,772	622,045	498,875	434,835	394,916	435,070
<b>Net Investment</b>	1,726,400	1,839,604	1,837,394	1,779,354	1,782,456	1,844,873	1,891,108
<b>Property Income (%)</b>	30.16%	30.76%	33.85%	28.04%	24.40%	21.41%	23.01%

Notes: Net Investment calculated as TPIS less accumulated depreciation, accumulated amortizations and deferred taxes.  
Property Income is calculated as operating revenues less total operating expenses, including depreciation. It is the income or return available for interest, dividends, return to stockholders and taxes.

Source: ARMIS Reports

**Table 6**  
**BellSouth Alabama Productivity**  
**Total Factor Productivity (TFP)**

<u>Total Output</u>	<u>1996</u>	<u>2002</u>	<u>Annual Growth</u>
Total Operating Revenues	1,185,520	1,382,621	
Revenue Changes From Price Changes	-9,251	-10,096	
Total Output/Price Adjusted Revenues	1,194,771	1,392,717	2.56%
 <u>Total Input</u>			
Total Operating Expenses	750,450	862,013	
Total Return	435,070	397,177	
Total Expenses	1,185,520	1,259,190	
GDP-PI	100.0	110.7	
Total Input/Price Adjusted Expenses	1,185,520	1,137,917	-0.68%
 Net Investment	1,891,108	1,726,400	
Required Return (%)	23.01%	23.01%	
Required Return (\$)	435,070	397,177	
 <u>TFP Growth</u>			3.24%

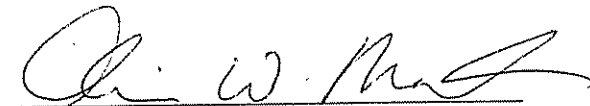
**Source:** Revenue, Expense and Investment data from ARMIS Reports  
GDP-PI from US Department of Labor, BLS

CERTIFICATE OF SERVICE

I hereby certify that on January 6, 2004, I have served a copy of the Comments of the Attorney General on Behalf of Alabama Ratepayers upon the persons below by United States Postal Service First Class Mail with postage prepaid:

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